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IN THE

Supreme Court of the United States

OCTOBER TERM, 1943

No. 44

JOHN V. DOBSON,

Petitioner,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE.

No. 45

E. W. DOBSON,

Petitioner,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE.

No. 46

ESTATE OF JAMES N. COLLINS, DECEASED, FIRST NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, EXECUTOR,

Petitioner,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE.

No. 47

H. J. HARWICK,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

BRIEF FOR PETITIONERS

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BRIEF FOR PETITIONERS

OPINIONS OF THE COURTS BELOW

The Board of Tax Appeals (now the Tax Court of the United States) reported its opinions in the cases of John V. Dobson, 46 B. T. A. 770 (R. 105), and Estate of James N. Collins, 46 B. T. A. 765 (R. 52). The memorandum opinions of the Board in the cases of E. W. Dobson (R. 79) and H. J. Harwick (R. 9) have not been officially reported. The Circuit Court of Appeals for the Eighth Circuit decided all of these case in a single opinion (R. 127), which is reported at 133 Fed. (2) 732.

GROUNDS UPON WHICH JURISDICTION IS INVOKED

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, 43 Stat. 938. The judgments (R. 136, 137, 138, and 139) of the United States Circuit Court of Appeals were entered on March 2, 1943, and a petition for writs of certiorari were filed in this Court on April 15, 1943. The writs of certiorari were granted on June 14, 1943.

STATEMENT OF THE CASE

These cases involve the legality under the Internal Revenue Code and the United States Constitution of treating as taxable income amounts recovered on an investment (through refund of part of the purchase price) under circumstances which establish conclusively that the taxpayers had not realized and would not realize any *gain* from such investment. The investments here involved consisted of corporate stock which had been sold at a loss by the purchasers prior to the year of recovery. Subsequently actions for rescission of the original purchase were settled by a return of a part

only of the original purchase price. The amounts of the recoveries were less than the losses sustained upon the sale by the purchasers and said losses, although referred to in the taxpayers' income tax returns for the year in which the sale occurred, did not offset any taxable income for the reason that said return already showed a net loss without using this particular deduction.[1]

The stipulated facts (Harwick, R. 18-26; James N. Collins, R. 59-64; E. W. Dobson, R. 84-89; John V. Dobson, R. 118-123) in each of the above cases, were adopted by the United States Board of Tax Appeals as its Findings of Fact (Harwick, R. 9-13; James N. Collins, R. 53-59; E. W. Dobson, R. 79-83; John V. Dobson, R. 105-110). Because neither party has distinguished between the facts involved in any of these cases in so far as the *general principle* involved in these cases is concerned and in the interests of clarity and brevity, we will hereinafter set forth only the facts involved in No. 46, Estate of James N. Collins, Deceased, First National Bank and Trust Company of Minneapolis, Executor, vs. Guy T. Helvering, Commissioner of Internal Revenue, and in No. 47, H. J. Harwick vs. Commissioner of Internal Revenue. However, for the convenience of the Court we have summarized the facts of the other two cases in Appendix A attached to this brief.

Several years before the taxable year 1939 the four taxpayers here, all residents of Minnesota, had made individual purchases in that state from National City Company of the stock of National City Bank of New York, and each had sold a portion or all of such stock at losses, which, except as hereinafter noted, were deducted on their income tax returns (R. 19, 60, 85, 119).

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[1]Slight variations in these facts exist in the J. V. Dobson and Harwick cases. The Circuit Court of Appeals for the Eighth Circuit in view of its decision in the other cases did not find it necessary to pass on the materiality of these variations.

James N. Collins[2] sold 100 shares of this stock in 1930, which had cost $56,200, for $14,599.20, and thereby sustained a deductible loss of $41,600.80, which the taxpayer referred to in his 1930 Federal income tax return and the deductibility of which was not questioned by the Commissioner of Internal Revenue (hereinafter referred to as the Commissioner) upon audit of the return.

Collins also sold 100 shares in 1931, which had cost $37,100, for $8,936.22, and sustained a loss of $28,163.78, which was referred to on his 1931 return and allowed by the Commissioner. Including these losses, the net loss disclosed in his income tax return for 1930 was $65,896.51, and for 1931, $40,204.90 (R. 62, 63). In addition to this stock Collins owned 100 shares of stock acquired at a cost of $30,000, which he continued to hold throughout the year 1939 (R. 60).

Several years after the above sales, Collins and the other taxpayers learned that grounds for rescinding these purchases existed. Accordingly, Collins filed suit against National City Company (R. 61), as did each of the other taxpayers except Harwick, who merely asserted a claim against that company, each contending:

1. That the stock had been sold to them without having been registered, as required by state law, and

2. That the sales had been fraudulent.

The complaint in each suit embodied a request for a rescission of the sales contracts and also an offer to turn over the proceeds of the stock sales or an equal number of shares, plus income thereon (R. 54).

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[2]Collins died on April 21, 1941, which was before his case was heard by the Board, and his executor was substituted as the petitioner, but for convenience Collins will be referred to here as the taxpayer (R. 15).

These suits, as well as Harwick's claim, were settled in 1939 by the company making payment to each of the taxpayers. Upon receipt of these payments the suits were dismissed with prejudice pursuant to a stipulation of the parties (R. 54). Harwick also executed an instrument releasing the National City Company from all claims which he had against it (R. 22).

As a result of this settlement James N. Collins received a net amount of $45,150.63, of which $23,296.45 was allocable to the stock sold in 1930 and $6,454.18 was allocable to the stock sold in 1931 (R. 51). The balance of the recovery was allocable to the stock which Collins still owned (R. 61). Collins did not report any of the recovery as income in 1939, but the first two amounts allocable to the stock sold in 1930 and 1931, viz.: $29,750.63, were held by the Commissioner to be taxable income (R. 62). The Commissioner has conceded that none of the recovery allocable to the stock which Collins continued to own constituted taxable income (R. 62).

Throughout the year 1939 adjustment of Collins' income tax liability for 1930 and 1931 was barred by the Statute of Limitations (R. 62, 63).

As to these recoveries in 1939, the Board held in effect that such payments constituted a return of capital and were not subject to tax unless the loss deductions of the prior years had actually offset gross income of those years and so had resulted in a tax benefit.

In applying this test the Board held as to James N. Collins (R. 58) that (1) since the amount received upon sale of the stock in 1930 and 1931, plus the amount recovered, was less than the original purchase price of the stock, viz.:

Stock sold in	1930		1931
Cost of stock.	$56,200.00		$37,100.00
Sale price ...	$14,599.20	$8,936.22	
1939 Recovery.	23,296.45	6,454.18	
Total Recovery	37,895.65		15,390.40
Net loss from transaction.	$18,304.35		$21,709.60

(2) and since the losses referred to in the taxpayer's 1930 and 1931 tax returns did not offset any income, viz.:

	1930	1931
Net *losses* per return.....	$65,896.51	$40,204.90
Eliminate entire loss on sale of National City Bank stock	41,600.80	28,163.78
Adjusted net *loss*.....	$24,295.71	$12,041.12

the taxpayer had not recovered or recouped his capital investment in this stock and therefore was not taxable on the sum recovered in 1939 allocable to the stock sold in 1930 and 1931.

While applying the same general principles in determining the tax liability of H. J. Harwick, the Board of Tax Appeals concluded that under the facts of that case the taxpayer was taxable on the entire amount of the recovery. These facts were as follows (R. 10-12):

On July 22, 1929, Harwick purchased 100 shares of the capital stock of the National City Bank of New York. The purchase was made in the State of Minnesota from the National City Company, the consideration being $38,000.

On December 15, 1931, Harwick sold the 100 shares of stock and sustained a loss by reason of said sale in the amount of $34,451.28. This loss was claimed as a deduction by him in his 1931 income tax return and was allowed by the Commissioner.

Harwick's claim against National City Company for rescis-

sion of this purchase was settled on March 7, 1939, by a net payment of $17,000 by the company, and upon receipt thereof, Harwick executed an instrument releasing the National City Company from all claims, demands, or causes of action which he ever had against it.

In his income tax return for 1939 Harwick reported income of only $9,884.22 on account of the recovery of the $17,000. In the deficiency notice the respondent adjusted the amount of income reported by adding thereto $7,115.78, thereby treating the entire amount of Harwick's net recovery of $17,000 as gross income, taxable as ordinary gain. If the entire deduction of $34,451.28 claimed and allowed on Harwick's 1931 income tax return, had been disallowed, a deficiency in his income tax liability for 1931 would have resulted in the amount of $3,349.53, computed as follows:

Net income per return		$12,042.03
Add: Loss on sale of National City Bank stock		34,451.28
Net income revised		$46,493.31
Less: Dividends	$11,861.81	
Personal exemption	3,500.00	
Credit for dependents	800.00	16,161.81
Balance subject to normal tax		$30,331.50
Total normal tax		1,296.58
Surtax on $46,493.31		2,539.20
Total		3,835.78
Less: Earned income credit		486.25
Total tax assessable		3,349.53
Assessed		None
Deficiency		$ 3,349.53

If Harwick had received $7,115.78 on the sale of the stock in 1931, in addition to the amount actually received, his deductible loss for 1931 from the sale of the said stock would

have been $27,335.50 instead of $34,451.28, and he would have had net income in the amount of $19,157.81. Due to certain credits allowable, however, his income tax for 1931 would have been zero, shown as follows:

Net income shown in original return		$12,042.03
Add: Amount recovered in 1939 and not reported as taxable income for 1939		7,115.78
Net income revised		$19,157.81
Less: Dividends	$11,861.81	
Personal exemption	3,500.00	
Credit for dependents	800.00	16,161.81
Balance subject to normal tax		$ 2,996.00
Normal tax at 1½%		44.94
Surtax on $19,157.81		186.30
Tax on net income		231.24
Less earned income credit		231.24
Total tax assessable		00.00
Tax assessed		None
Deficiency		None

Throughout the year 1939 adjustment of Harwick's income tax liability for 1931 was barred by the Statute of Limitations.

The Board of Tax Appeals held that although $7,115.78 of the total loss of $34,451.28 had not reduced Harwick's tax liability in 1931, nevertheless all of the 1939 recovery of $17,000 constituted taxable income. The reason given by the Board for refusing to recognize the capital nature of any portion of said recovery was that the entire loss had been used to offset gross income, inasmuch as even after deduction of said loss the 1931 return disclosed a "net income" of $12,042.03, and therefore in the opinion of the Board the

loss had served to "effect an offset of taxable income" (R. 13).

Although the general facts with respect to the John V. Dobson case are set out in Appendix A, one special fact should be noted at this point. On July 3, 1931, John V. Dobson purchased 200 shares of the bank stock at a cost of $17,700, and on July 13, 1931, he sold the said shares for $16,000, thereby sustaining a loss of $1,700 which was deductible for 1941 but not classed as a deduction in his income tax return for that year. Upon audit of the return no deduction was allowed by the Commissioner by reason of the loss realized on the sale but had such loss been claimed as a deduction it would have been allowed and would have reduced the income tax liability of John V. Dobson for the year 1931, but would not have eliminated entirely his liability for tax. His 1931 return disclosed net income of $17,514.27 and a tax thereon of $125.43, which was paid to the Collector during the year 1932 (R. 106).

As a result of John V. Dobson's suit against National City Company for rescission of this and other purchases of stock, John V. Dobson recovered from that company in 1939 the net sum of $33,404, of which $952 is allocable to the stock referred to above sold by John V. Dobson in 1931. The Commissioner conceded before the Board and the Board held (R. 110) that no part of this portion of the recovery constituted income taxable to John V. Dobson in 1939.

From these decisions of the Board the Commissioner appealed in the cases involving the tax liability of E. W. Dobson (R. 89), James N. Collins (R. 64), and John V. Dobson (R. 111). The taxpayer H. J. Harwick appealed (R. 14) and John V. Dobson took a cross-appeal (R. 33) from the portion of the decision of the Board dealing with the application of the principle referred to above to their particular facts, and from the portion of the decision of the Board

holding that to the extent that taxable income resulted from the recoveries such income was taxable as ordinary income rather than as capital gain under Section 117 of the Internal Revenue Code. The cases were consolidated before the Circuit Court of Appeals for the Eighth Circuit and on March 2, 1943, that Court entered the following decision (R. 127):

As to the appeals taken by the Commissioner, the Court reversed the decision of the Board and held that the entire amounts recovered by the taxpayers in 1939 from National City Company constituted taxable income for the reason that according to the Court (R. 133) the recoveries were "income when received" and, constituting income, could not be reduced by losses sustained in a year prior to 1939 (R. 132). The Court therefore refused to pass on the first issue raised in the appeals by Harwick and John V. Dobson (R. 134), and as to the second issue raised by them the Court affirmed the decision of the Board and held that the entire amount recovered was taxable as ordinary income and not as capital gain (R. 135).

SPECIFICATIONS OF ERROR

The Circuit Court of Appeals erred:

1. In holding that the recoveries realized by the taxpayers in 1939 as the result of rescissions of previous stock purchases constitute income in that such recoveries in fact constitute recoveries of capital which cannot be taxed under Section 22 (a) of the Internal Revenue Code, 53 Stat. 9; 574-575, nor under Article XVI, Amendments to the Constitution of the United States, except where by reason of previous actions of the taxpayers which resulted in tax benefit to them they are prevented from asserting the capital nature of such recoveries;

2. In refusing to determine that the Board of Tax Appeals erred in finding that the taxpayers Harwick and John V. Dobson were prevented from asserting the capital nature of the recoveries in situations in which the losses sustained by reason of sales during prior years offset gross income but in part or in whole did not serve to reduce tax liability of the taxpayers in such years, in that such facts are insufficient to prevent the taxpayers from asserting the capital nature of such recoveries;

3. In holding that to the extent that said recoveries constitute taxable income, such income is taxable as ordinary income rather than as capital gain under Section 117 of the Internal Revenue Code, 53 Stat. 50.

ARGUMENT

I.

The Recoveries Realized by the Taxpayers in 1939 as the Result of Rescissions of Previous Stock Purchases Constitute Recoveries of Capital Which Cannot Be Taxed Under Section 22 (a) of the Internal Revenue Code, Nor Under Article XVI, Amendments to the Constitution of the United States.

The facts in these cases are clear. It has been stipulated (R. 19, 61, 86, 120) that the taxpayers' claims upon which recoveries were realized arose out of the discovery in 1936, 1937, or 1938 of facts which led each of them to believe that the National City Bank of New York stock purchased by them had not been registered in accordance with the requirements of the Minnesota Blue Sky Laws and that said sales had been fraudulent. In addition to this stipulation the factual basis for the contention that the recoveries from National City Company did not consti-

tute income is most clearly illustrated by the facts involved in the James N. Collins case. Collins acquired his stock in 1929 and sold it in 1930 and 1931 at a substantial loss (R. 60). Had Collins not claimed *any* loss as a result of such sales in his 1930 and 1931 returns, such returns, nevertheless, would have disclosed losses of $24,295.80 and $12,041.12, respectively (R. 62, 63). Furthermore, the sum of the sales price of the stock in 1930 and 1931, plus the amounts recovered in 1939, was less than the original cost of the stock to Collins (R. 61). The importance of these facts with respect to the effect of the sales upon Collins 1930 and 1931 tax liability is that (1) they clearly show that as a result of the sales in 1930 and 1931 *and* the recovery in 1939 Collins did not realize any *gain* but, on the contrary, sustained a *loss,* and (2) they negative any conclusion that Collins is estopped to assert or can be said to have waived his right to claim that there was no *gain* as a result of the recovery in 1939, and that such recovery constituted a receipt of capital. The variations in these facts which exist in the Harwick case and, to a small extent, in the John V. Dobson case, will be discussed later in this brief.

Under both local property law and decisions of this Court interpreting the income tax laws, the status of these recoveries as capital receipts rather than income is clear. The Minnesota Supreme Court has held upon numerous occasions that claims such as here involved are based upon a rescission of the contract of sale and a recovery of the purchase price.

Babcock vs. Bancamerica-Blair Corporation (1942), 212 Minn. 428, 4 N. W. (2d) 89;

Vercellini vs. U. S. I. Realty Co. (1924), 158 Minn. 72, 196 N. W. 672;

E. E. Webster vs. U. S. I. Realty Co. (1927), 170 Minn. 360, 212 N. W. 806;

Drees vs. Minnesota Petroleum Co. (1933), 189 Minn. 608, 250 N. W. 563;

Edson vs. O'Connell (1934), 190 Minn. 444, 252 N. W. 217;

See, also, *Vogel vs. Chase Securities Corporation* (1936), 19 Fed. Supp. 564.

The Board of Tax Appeals also characterized these recoveries as resulting from a rescission of the original sale (R. 55) and the Commissioner has not questioned this conclusion. It cannot be disputed that the recoveries were a return from the original seller to the taxpayers of a part of their capital invested in the stock. The restitution is more direct, and more clearly identified with the capital investment than the recovery on a tort claim for damages for trespass and removal of coal involved in *Strother vs. Commissioner of Internal Revenue* (C. C. A. 4th Cir., 1932), 55 F. (2d) 626, affirmed on other grounds in (1932) 287 U. S. 314, 53 Sup. Ct. 11, 77 L. Ed. 511, and the recovery on a tort claim for damages for interference with business in *Farmers & Merchants Bank vs. Commissioner of Internal Revenue* (C. C. A. 6th Cir., 1932), 59 F. (2d) 912, both of which were held to be return of capital, and not income.

The situation thus presented is that the taxpayers, having invested their capital in stock of the National City Bank, have had returned to them a part of that capital through sale of the stock in 1930 and 1931, and another part through settlement of litigation seeking rescission of the original purchase, but are still out of pocket because they have not recovered it all. It is this second, and still incomplete, return of capital which the Commissioner seeks to designate as income.

Congress has defined "gross income" in a manner which clearly excludes the recoveries of the taxpayers here involved.

Section 22 (a) of the Internal Revenue Code, 53 Stat. 9, provides in part:

> "(a) General definition—'Gross income' includes *gains, profits,* and *income* derived * * * from * * * business * * * or sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from * * * the transaction of any business carried on for *gain* or *profit,* or *gains* or *profits* and *income* derived from any source whatever." (Italics added.)
>
> See Amendments to the Constitution of the United States, Art. XVI.

The taxpayers assert that the portion of the recoveries from National City Company here involved did not constitute "gain or profit" within the above statutory definition. This Court in construing similar statutory provisions has held that recoveries of capital which do not represent gain or profit cannot be subjected to tax.

The basic definition of income, approved by this Court in a long series of cases, is found in *Eisner vs. Macomber* (1920), 252 U. S. 189, 206, *et seq.,* 40 Sup. Ct. 189, 64 L. Ed. 521, where this Court said:

> "For the present purpose we recognize only a clear definition of the term 'income' as used in common speech in order to determine its meaning in the amendment * * *. Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit through a sale or conversion of capital assets * * *."

In accordance with this definition, it has been held repeatedly that, where the taxpayer has invested his capital in property or securities which are sold or lost or otherwise liquidated, and subsequently payments are made to him by way of reimbursement, there can be no "income" in connection with such payments until the full amount of the orig-

inal capital has been returned. It is only profit or gain beyond the capital investment which constitutes income. This was the rule applied to statutes taxing income before the Sixteenth Amendment, and it has carried over as a part of the definition of income under that amendment. "In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

Doyle vs. Mitchell Bros. Co. (1918), 247 U. S. 179, 185, 38 Sup. Ct. 467, 62 L. Ed. 1054;

Hays vs. Gauley Mt. Coal Co. (1918), 247 U. S. 189, 38 Sup. Ct. 470, 62 L. Ed. 1061;

Lynch vs. Turrish (1918), 247 U. S. 221, 38 Sup. Ct. 537, 62 L. Ed. 1087;

Burnet vs. Logan (1930), 283 U. S. 404, 51 Sup. Ct. 550, 75 L. Ed. 1143;

Commissioner of Internal Revenue vs. Speyer (C. C. A. 2d Cir., 1935), 77 F. (2d) 824;

Commissioner of Internal Revenue vs. Ullman (C. C. A. 2d Cir., 1935), 77 F. (2d) 827;

Dreier vs. Helvering (App. D. C., 1934), 72 F. (2d) 76;

Helvering vs. Dreier (C. C. A. 4th Cir., 1935), 79 F. (2d) 501.

This Court applied the above definition of income in the case of *Bowers vs. Kerbaugh-Empire Co.* (1926), 271 U. S. 170, 46 Sup. Ct. 449, 70 L. Ed. 886. The taxpayer in that case had borrowed money under a contract requiring repayment in German marks. After the declaration of war upon Germany the unpaid balance on this loan was paid off in German marks which at that time had greatly depreciated in value. As a result the difference between the United

States dollars, into which proceeds of the original loan had been converted, and the United States dollars necessary to purchase the depreciated marks with which to pay off the loan was $684,456.18. The money when borrowed had been used in construction projects by the taxpayer and its subsidiary but these projects had resulted in substantial net losses prior to the year in which the debt was paid. The Court, page 172, pointed out that the losses sustained in such prior years were in excess of the asserted income, viz.: $684,456.18, and stated that these were among the "essential facts" which supported the conclusion that this transaction did not result in income. The Court further stated, page 174, that "In determining what constitutes income, substance rather than form is to be given controlling weight," and concluded, page 175, that "The mere diminution of loss is not gain, profit, or income."

The importance of the fact in the *Kerbaugh-Empire Co.* case, *supra,* that the transactions in prior years had resulted in net losses and the recognition of this Court that whether or not such losses existed would determine the taxable character of subsequent capital transactions is demonstrated by later citations of that case by this Court. *United States vs. Kirby Lumber* Co. (1931), 284 U. S. 1, 3, 52 Sup. Ct. 4, 76 L. Ed. 131; *Helvering vs. American Chicle Co.* (1934), 291 U. S. 426, 430, 54 Sup. Ct. 460, 78 L. Ed. 891.

The decision in the *Kerbaugh-Empire Co.* case was based on and represented an extension of previous decisions in which this Court had held that a recovery of capital on an asset *held by the taxpayer at the time of the recovery* does not constitute income under the Sixteenth Amendment. See *Miles vs. Safe Deposit & Trust Co.* (1922), 259 U. S. 247, 42 Sup. Ct. 483, 66 L. Ed. 923; *Towne vs. Eisner* (1918), 245 U. S. 418, 38 Sup. Ct. 158, 62 L. Ed. 372; and *Eisner vs. Macomber, supra.*

The definition of income in *Eisner vs. Macomber, supra,* also was approved by this Court in *Goodrich vs. Edwards* (1920), 255 U. S. 527, 41 Sup. Ct. 390, 65 L. Ed. 758. That case involved Sec. 2 (c) of the *Revenue Act of 1916,* 39 Stat. 758, which provided that "For the purpose of ascertaining the gain derived from a sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, the fair market price or value of such property as of March 1, 1913, shall be the basis for determining the amount of such gain derived." The Commissioner had ruled that under this statute the March 1, 1913, value was to be used in determining gain, even though that value was less than the cost to the taxpayer. The Court rejected this contention, emphasizing that the *Revenue Act of 1916* (similar in this respect to the statute here involved) imposed no tax except where *gains* were realized. Although the Solicitor General confessed error in the *Goodrich* case, the Court later reaffirmed its conclusions and stated that its decision was not based on this confession of error. *United States vs. Flannery* (1925), 268 U. S. 98, 103, 45 Sup. Ct. 420, 69 L. Ed. 864.

In the case of *Koshland vs. Helvering* (1936), 298 U. S. 441, 56 Sup. Ct. 767, 80 L. Ed. 1268, the Commissioner contended that where common stock was received by a taxpayer as a dividend on preferred stock in the same corporation, the cost of said preferred stock for purposes of determining gain upon redemption thereof was not to be reduced by apportioning part of the cost to the common stock. The requirement of apportionment was embodied in regulations promulgated by the Commissioner. The Court held that the rule laid down by the regulation was invalid and therefore the basis for the preferred stock was not reduced. The holding was based on this proposition, page 447:

"Congress having clearly and specifically declared

that in taxing income arising from capital gain the cost of the asset disposed of shall be the measure of the income, the Secretary of the Treasury is without power by regulatory amendment to add a provision that income derived from the capital asset shall be used to reduce cost."

In short, it is the contention of the taxpayers that there can be no income, within the meaning of the word as it is used in the Revenue Acts, and that Congress has no power under the Sixteenth Amendment to find income, in a capital transaction which has resulted in no profit or gain, but on the contrary represents a loss.

II.

The Reference to the Capital Loss in the Returns for 1930 and 1931 Does Not Make the Later Recovery of Capital Income, or Prevent the Taxpayers from Asserting Its Capital Nature, in the Absence of Tax Benefit to Them and Loss of Revenue to the Government.

The Circuit Court of Appeals for the Eighth Circuit stated that the above facts and authorities were immaterial, and without citation of any authority or further explanation, other than the statement that the capital transaction was closed when the stock was sold, the Court concluded that the recoveries were income when received (R. 133). The Circuit Court of Appeals then proceeded to demonstrate, with ample citation of authority, that losses and deficits for prior years could not be used to offset or reduce income for the current year (R. 132). The petitioners submit that the basic and erroneous premise in the conclusion of the Circuit Court of Appeals is the proposition that these recoveries were income when received and that this premise has no support in the facts or the authorities.

The statement of the Court, in support of its assumption that the recoveries here involved were income, that the capital transaction was closed when the stock was sold apparently is based on the proposition that in income tax accounting the transactions of each year must be separate and distinct and closed at the end of the year and not to be considered in relation to any subsequent year. In support of this theory, reliance is placed upon *Burnet vs. Sanford & Brooks Co.* (1931), 282 U. S. 359, 51 Sup. Ct. 150, 75 L. Ed. 383.

In that case the taxpayer performed a contract for the United States Government which resulted in the realization of losses by the taxpayer while the contracts were being performed during the years 1913 to 1916. Subsequent to the abandonment of the work the taxpayer sued the United States and recovered additional compensation under the contract. This recovery was received by the taxpayer in 1920 and this Court sustained the Commissioner in including the recovery in taxpayer's income for 1920, despite the fact that because of losses sustained on the Government work in 1913 to 1916, the taxpayer's income tax return had shown large net losses for all years except 1914. The basis for the decision was the conclusion that the recovery in 1920 constituted gross income for that year and that there was no statutory authority for disregarding the annual accounting periods so as to permit the bringing forward of losses sustained in prior years. It is apparent that the essential premise for the Court's conclusion is the finding that the money which was received was an income as distinguished from a non-income item such as a return of capital or refund of previous expenditures. This Court expressly recognized the principle upon which we are here relying. The Court said, page 363:

"That the recovery made by respondent in 1920 was

gross income for that year within the meaning of these sections cannot, we think, be doubted. The money received was derived from a contract entered into in the course of respondent's business operations for profit. While it equalled, and in a loose sense was a return of, expenditures made in performing the contract, still, as the Board of Tax Appeals found, the expenditures were made in defraying the expenses incurred in the prosecution of the work under the contract, for the purpose of earning profits. *They were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income.* See *Doyle vs. Mitchell Brothers Co., supra,* page 185 of 247 U. S., 38 Sup. Ct. 467." (Italics ours.)

It is evident that the basis of this decision is that the expenditures in prior years of the kind recognized as ordinary operating expenses gave rise to losses in such prior years and *only* in such prior years, and in the absence of statutory authority such losses could not be used to offset income received in subsequent years. The opinion does not mean that in determining whether a given capital transaction resulted in gain or loss the inquiry is limited to the events which occurred in a single year. This is made all the more clear by the fact that the Court distinguished but did not disturb the case of *Bowers vs. Kerbaugh-Empire Co., supra,* where losses of invested capital sustained in earlier years were taken into account in determining that no income resulted from a return of capital. It is of course entirely reasonable that current receipts and current operating expenses of a business should be closed each year; but it is the very essence of gains and losses on invested capital that they be considered over a long term.

The distinction is borne out by *Wichita State Bank & Trust Co. vs. Commissioner of Internal Revenue* (C. C. A. 5th Cir., 1934), 69 F. (2d) 595, certiorari denied, 293 U. S. 562, 55 Sup. Ct. 73, 79 L. Ed. 662. Here the taxpayer, in

common with other banks, made contributions to a permanent guaranty fund for the benefit of failed banks. The fund was not intended to be consumed, but was to be drawn on to provide prompt payment to depositors, and at once to be replenished by special assessments against member banks. Certain banks having failed, such special assessments were levied against the taxpayer; in later years, partial reimbursement was made by dividends from the assets of the failed banks. It was held that the special assessments were to be treated as ordinary, current expense of the business, which must be charged off in the year they were incurred, so that the reimbursement was income in the year it was received. Return of the contributions made to the standing guaranty fund, however, was held to be a return of capital, on which there could be no income in the absence of a gain on the transaction over the long term.

A similar result was reached in *Buffalo Union Furnace Co. vs. Helvering* (C. C. A. 2d Cir., 1934), 72 F. (2d) 399. In that case the taxpayer, both before and after March 1, 1913, had expended money for car spotting, which should have been done by carriers. After March 1, 1913, it deducted the cost of this work on its income tax returns. In 1921, after suit and settlement, it recovered a part of its claim from the carriers. It was held that, as to all expenditures after March 1, 1913, these operating expenses were closed in the year in which they were deducted, and the reimbursement was income to that extent in 1921. But as to expenditures before March 1, 1913, the taxpayer entered the income tax zone with claims against the railroads for past torts, which became a part of its capital; and until it could be shown that these claims were paid at an amount in excess of their March 1, 1913, value, no income resulted in 1921.

The conclusion is that the Circuit Court of Appeals is in error in its opinion that gains and losses on invested capital

must be closed out each year, rather than considered on the basis of the transaction as a whole.

There remains the question whether, by reason of the fact that the taxpayers listed the losses realized as a result of the sales of stock on their returns for 1930 and 1931, without deriving any tax benefit from them, they are now prevented from treating the recoveries in 1939 as a return of capital. The petitioners freely concede that, if the losses so listed had been of tax benefit to them, they would be precluded from raising the contention that the subsequent recoveries are not income.[3] One sufficient reason for this is that by taking advantage of such a benefit the taxpayer allots a portion of otherwise taxable income to the restoration of his lost capital, which is thus returned, and any subsequent recovery must be gain.[4] Another, perhaps, under general equitable considerations, is a form of estoppel, in that the government has been deprived of revenue through the taxpayer's claim that he has sustained a loss.[5]

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[3]There is ample authority for this.
Ilfeld Co. vs. Hernandez (1934), 292 U. S. 62, 54 Sup. Ct. 596, 78 L. Ed. 1127;
Griffiths vs. Commissioner (1939), 308 U. S. 355, 60 Sup. Ct. 277, 84 L. Ed. 319;
Helvering vs. Owens (1939), 305 U. S. 468, 59 Sup. Ct. 260, 83 L. Ed. 292;
Sec. 113 (b) (1) (A), **Internal Revenue Code**, 53 Stat. 44;
Sec. 19.113 (b) (1)-1, **Regulations 103**;
Secs. 23.33 and 23.34, **Regulations 104.**

[4]"* * * the income tax laws permit the bank to recoup its capital by deducting from the profits or income the amount of the loss. Thus the bank does not pay a tax on all its income, but on the amount of income less the loss on the worthless debt. The debt itself then loses its nature as capital, but represents that portion of the income which was not taxed, and the capital is the money taken from the profits or income. If the loan, after being deducted from income, is paid, then the lender is receiving profit or income—otherwise the lender would double its capital on one transaction. In other words, the profits or income used to pay back the capital when the debt is charged off is represented by the worthless loan, so that when such loan is paid the profits are replaced."
National Bank of Commerce of Seattle vs. Commissioner of Internal Revenue (C. C. A. 9th Cir., 1940), 115 F. (2d) 875.

[5]The development of similar equitable doctrines with respect to the Federal income tax laws under the terminology of "equitable estoppel," "quasi estoppel," and "election" has been discussed in Maguire & Zimet, Hobson's Choice in Federal Taxation, 48 Harvard Law

No such situation is presented here. The taxpayers derived no tax benefit from the losses listed in 1930 and 1931. No portion of otherwise taxable income was allocated to return of the invested capital, beyond which any further return must be gain. There was no such otherwise taxable income to allot; without the losses in question, there was still a net loss. The government was not deprived of revenue, since even without these losses there was nothing to be taxed. No equitable estoppel can arise. Nor is there any irrevocable election on the part of the taxpayers through mere listing of losses in 1930 and 1931, to have them considered in that year or not at all—since, when the government itself reopens the matter by its demand for taxes on the payments received in 1939, the taxpayers may claim recoupment on the basis of the transaction as a whole.

Bull vs. United States (1934), 295 U. S. 247, 55 Sup. Ct. 695, 79 L. Ed. 1421;

Dixie Margarine Co. vs. Commissioner of Internal Revenue (C. C. A. 6th Cir., 1940), 115 F. (2d) 445.

The principle contended for by the petitioners in these cases originally was adopted by the Commissioner. In G. C. M. 18525, 1937-1 C. B. 82, the Commissioner concluded that where bad debts are charged off and deducted in an income tax return, subsequent recoveries on such bad debts constitute taxable income only where the deduction "accomplished a reduction in tax liability and [previous statements with

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Rev. 1281, 1293, et seq., and 39 Columbia Law Rev. 305. It would appear that the petitioners' factual misrepresentation in 1930 and 1931, i. e., that a loss in a specified amount had been sustained, contains all of the elements of even a technical equitable estoppel where the loss was of tax benefit to them with a single possible exception. That exception is the requirement that the person against whom the estoppel is asserted must have knowledge of the true facts at the time of the misrepresentation. Whether this element is in fact essential to the existence of equitable estoppel or whether some other equitable doctrine is applicable to these cases is immaterial in view of the petitioners' concession.

respect to the taxability of such recoveries] do not refer to deductions for bad debts in cases in which the taxpayer on account of other allowable deductions had no net income, irrespective of the deduction for bad debts." The Commissioner further stated in G. C. M. 20854, 1939-1 C. B. (Part 1) 102:

> "In any case in which a bad debt has been allowed as a deduction and has had the effect of offsetting taxable income (meaning, for present purposes, income which would be the basis for the computation of a tax liability), the taxpayer has, to that extent, in effect had the benefit of a recovery of capital for income tax purposes. In determining the extent, if any, to which a taxpayer has thus benefited, the credits against net income provided in the Revenue Acts must be taken into account. To the extent that a deduction does not result in such a benefit to the taxpayer, the deduction can not be said to have accomplished a return of capital. Until a taxpayer has had the income tax equivalent of a full return of the capital represented by his debt, there is no valid ground for treating as income any amount received in recovery of the debt."

In 1940 the Commissioner reached the contrary conclusion and revoked the above rulings by G. C. M. 22163, 1940-2 C. B. 76. Following this ruling, Congress, in the *Revenue Act of 1942*, Sec. 116 (a), 56 Stat. 812, amended Sec. 22 (b) of the Internal Revenue Code to provide expressly that recoveries of bad debts, prior taxes or other specified items for which deductions were allowed in prior years shall be included in gross income only to the extent that they represent a tax benefit to the taxpayer on returns for prior years.

There is nothing in *United States vs. Ludey* (1927), 274 U. S. 295, 47 Sup. Ct. 608, 71 L. Ed. 1054, opposed to the contentions of the petitioners in this case. That case involved the question as to the propriety of adjustments to basis for depletion and depreciation allowable although not

claimed by the taxpayer. The decision of the Court that the basis must be reduced by the full amount allowable was based on the proposition that depreciation and depletion represent a loss of capital which actually occurs. The Court further held that a taxpayer is not to be permitted to juggle the deduction for depreciation and depletion between various tax years, inasmuch as it occurs ratably during each year. The failure of a taxpayer to claim in its tax returns the full amount of depreciation and depletion allowable represented a failure to take account of the capital then recovered, whereas in these cases the taxpayers recovered nothing in 1930 or 1931 in addition to the sale price of the stock, which sale price was substantially less than the original capital investment.

The decision of this Court in the case of *Virginian Hotel Corporation vs. Helvering* (1943), ... U. S. ..., 87 L. Ed. 1149, ... Sup. Ct. ..., is not opposed to the above contentions and authorities. The question presented by that case was whether in computing depreciation on a straight line basis for the year 1938, the taxpayer was required to reduce the cost of the property by the amount of depreciation referred to in its tax return for prior years, although admittedly the amount thereof was in excess of the amount properly deductible for such prior years and the amount of such *excess* had not served to reduce the tax liability of the taxpayer because other deductions were sufficient to reduce its taxable income to zero. Section 113 (b) (1) (B) of the *Revenue Act of 1938* was applicable to the problem and provided that the cost should be reduced by depreciation "to the extent allowed (but not less than the amount allowable)" during years prior to 1938. This Court in construing the statute held that the quoted phrase did not connote the receipt of a tax benefit but merely required that the deduction be claimed in the taxpayer's returns. The decision

was not based on a determination as to the concept of income but on the narrow issue as to whether Congress in granting a *deduction* from income intended to condition the computation of the particular deduction in the manner claimed by the taxpayer. The Court held that Congress did not intend to provide (and presumably was not required to provide) for a means whereby a taxpayer will be guaranteed that he will recover *through deductions from income* the entire cost of a depreciable asset. This Court has frequently held that the matter of granting deductions depends upon legislative grace. *Deputy vs. DuPont* (1940), 308 U. S. 488, 493, 84 L. Ed. 416, 60 Sup. Ct. 363; *New Colonial Ice Co. vs. Helvering* (1934), 292 U. S. 435, 440, 78 L. Ed. 1348, 54 Sup. Ct. 788. This rule as illustrated by the decisions of this Court cited in support of our contentions has never been extended to questions involving the distinction between capital and income. The existence of taxable income depends upon the existence of *gain* and Congress has not legislated and does not have the power to legislate to the contrary. The exemption of capital receipts from the impact of the income tax is not a matter of legislative grace.

Both dissents in the *Virginian Hotel Corporation* case were based on a disagreement as to the proper construction to be given to the statute involved. Neither the majority nor the dissenting opinions in that case are decisive of the problems here involved, inasmuch as they are both based on a construction of a section of the statute not material to these cases.

In footnote 8 to the decision in the *Virginian Hotel Corporation* case the Court raises the question as to the correctness of the theory that where a return discloses a net loss a particular deduction may be singled out as offsetting gross income, even though it is one of several deductions which are claimed. We believe that the answer to the question is

at once practical and simple. It is obvious that no one can assert that deduction A (deductions other than the loss on sales of National City Bank stock) was used to offset gross income, and deduction B (the loss on sale of National City Bank stock) was not so used where a net loss in excess of either deduction results from both deductions, but a net income would result if both were eliminated as deductions. It seems equally obvious that this fact is immaterial under the theory which forms the basis for our contentions. This theory is that the recoveries here involved are recoveries of capital and cannot be taxed unless for some reason based on valuable benefits previously received by the taxpayer and corresponding detriments suffered by the Government the taxpayer is prevented from asserting the capital nature of the recoveries. One of the universally recognized elements of any form of equitable estoppel is that the person asserting the estoppel has suffered some loss or damage. *Maguire & Zimet,* Hobson's Choice in Federal Taxation, 48 Harvard Law Review 1281, 1293; *et seq.; Pomeroy's Equity Jurisprudence,* Fourth Edition, Paragraphs 804, 805 and 812; *Lansing McVickar* (1938), 37 B. T. A. 758, 761. The Government clearly suffered no loss or damage as a result of the fact that the taxpayers claimed losses in their 1930 and 1931 returns, inasmuch as the elimination of these losses (to the extent of the 1939 recoveries claimed to be nontaxable) would not have resulted in any tax liability for those years. The fact that if such losses had been eliminated *and* if other deductions had also been eliminated a tax liability for 1930 or 1931 would have existed, does not create the necessary element of loss or damage to the Government. None of the deductions other than the losses on sales of National City Bank stock were questioned upon audit of the 1930 and 1931 returns or in this proceeding. To find loss or damage to the Government sufficient to support an

estoppel by reason of the fact that at some time in the future these other deductions conceivably may be questioned would represent a highly inequitable application of an equitable doctrine. See *Maguire & Zimet,* Hobson's Choice in Federal Taxation, 48 Harvard Law Review 1281, 1315, and *Pomeroy's Equity Jurisprudence,* Fourth Edition, Paragraph 813.

One other answer to the problem raised by this Court in footnote 8 of its decision in the *Virginian Hotel Corporation* case has been suggested by the court in *Philadelphia National Bank vs. Rothensies* (D. C. Pa., 1942), 43 Fed. Supp. 923. The court there held that the burden of proving an estoppel against the right of the taxpayer to assert the capital nature of a recovery is upon the Government and that, therefore, the Commissioner must show (as applied to the facts of our case) that losses in 1930 or 1931 upon sale of National City Bank stock, as distinguished from other deductions claimed and allowed in returns for such years, did in fact result in a tax saving to the taxpayer. The Commissioner has not sustained such a burden in these cases.

The above contentions lead to consideration of the application of the rule in situations in which two capital recoveries are made in successive years, e. g., 1939 and 1940, with respect to separate transactions, both of which resulted in deductible losses for a single prior taxable year, e. g., 1930. Treatment of the capital recovery during 1939 in such a case would be no different than that proposed by the taxpayers in these cases. However, in determining the treatment of the capital recovery in 1940, the Commissioner would be able to assert an estoppel based on the reduction in tax liability for 1939, assuming that the adjustments made in the 1930 tax return by reason of the 1939 recovery had sufficiently eliminated the net loss for 1930 so that further adjustments would produce tax liability for 1930. There is little to be gained by further discussion of such

involved fact situations, but the above example demonstrates that the petitioners' theory is sufficiently flexible to meet any similar problem likely to arise.

The Commissioner has conceded that John V. Dobson is not prevented from asserting the capital nature of the recovery in 1939 under facts which are similar to those here involved in so far as the problem discussed immediately above is concerned. John V. Dobson sold 200 shares of stock at a loss of $1,700 in 1931, which loss was deductible in his tax return for that year but was not claimed in his return nor allowed on audit (R. 105). Had the loss been claimed, a tax saving for 1931 would have resulted. In 1939 John V. Dobson recovered $952 of this loss through an action instituted against National City Company. The Commissioner conceded before the Board and the Board held that this recovery did not constitute taxable income (R. 110). If, as the Commissioner concedes, the taxpayer is permitted to assert the capital nature of the recovery in such a case, it follows that the mere fact that a loss was referred to in the 1930 or 1931 tax returns should not be held to constitute sufficient valuable benefits to the taxpayer and detriment to the Government to prevent the taxpayer from asserting the capital nature of subsequent recoveries attributable to transactions giving rise to such losses. There is no greater legal or practical difficulty in separating deductions A and B where both are claimed in the return than in separating deductions A and B when deduction B, through inadvertence or otherwise, is not claimed in the return. The fact that the Commissioner found it legally or administratively desirable to make the above concession in the John V. Dobson case demonstrates the fundamental error in his position before this Court.

III.

The Recoveries Realized by John V. Dobson and Harwick Were in Whole or in Part Within the Above Rule, Even Though After Deduction for the Entire Losses Sustained Upon the Sales in 1930 and 1931 a Statutory "Net Income" Remains But Where All Tax Was Eliminated by Statutory Credits Against "Net Income."

As a result of sales of the bank stock in 1931 Harwick sustained losses of $34,451.28 and claimed this deduction in his 1931 income tax return. That return disclosed statutory "net income" of $12,042.03 but also disclosed the following statutory credits against or deductions from "net income":

Dividends	$11,861.81
Personal exemption	3,500.00
Credit for dependents	800.00
	$16,161.81

These credits, plus a credit against the *tax* designated by the *Revenue Act of 1938* as an "earned income credit," eliminated all tax liability on the return and would also have eliminated all tax liability had the loss on sale of National City Bank stock actually been $7,115.78 less than the amount claimed and allowed in 1931 (R. 10-12).

In view of the above facts, Harwick asserts (as to a small extent under similar facts does John V. Dobson) that he received no valuable benefits from his loss in 1931 and the Government sustained no loss of revenue therefrom which prevent him from asserting that $7,115.78 of his recovery out of a total recovery of $17,000 in 1939 was a recovery of capital. The Board of Tax Appeals, although accepting the general contentions of the other taxpayers, refused to accept this analysis of the problem and held that to the extent that

the recovery in 1939 when added back to the 1930 or 1931 losses produced a statutory "net income" such recoveries were taxable income. In the Harwick case, inasmuch as the original return disclosed a statutory net income, the Board held that the entire recovery in 1939 was taxable. Because the Circuit Court of Appeals reversed the Board on the general issue, it was not necessary for that Court to consider this problem and it did not do so.

It is the contention of Harwick and John V. Dobson (1) that in determining valuable benefits received by the taxpayer and detriment sustained by the Government under the theory advanced in part I above the sole consideration which has any reality is whether any reduction in tax liability resulted, and (2) that the statutory concept of "net income" is so arbitrary as to be of no value in a problem such as this. If our theory is sound, the first contention is sufficient to support Harwick's and John V. Dobson's position. Congress has recently adopted this theory with respect to recoveries on bad debts previously charged off. Section 116 of the *Revenue Act of 1942*, 56 Stat. 812, provides in part that recoveries on bad debts previously charged off are not income if and to the extent that the previous chargeoff did not "result in a reduction of the taxpayer's tax." The report of the Senate Finance Committee on this section, page 80, Report No. 1631, states that:

> "In determining whether and to what extent the deductions and credits on account of bad debts, taxes and delinquent amounts allowed in a given year did not result in a tax benefit, such deductions and credits are to be regarded as having been the last ones taken and those as having off-set such *gross income or tax as was not off-set by the other deductions or credits.*" (Italics added.)

It is apparent from the above provisions of Section 126 and the Senate Finance Committee report that Congress has

adopted the test as to "tax benefit" which is here urged by Harwick and John V. Dobson. Inasmuch as we understand that this amendment was a Treasury proposal, it no longer is open to the Commissioner to argue as he did before the Board and the Circuit Court of Appeals that the taxpayers' test as to tax benefit is too complicated and unworkable. We, therefore, submit that the same sound reasons which prompted Congress and the Treasury to establish this particular test as to tax benefit should govern this Court in deciding these cases.

The second contention with respect to the arbitrary basis of the statutory concept of net income requires an analysis of the *Revenue Act of 1928*, 45 Stat. 791, *et seq.* Under the Revenue Act of 1928, as under all Revenue Acts, the "net income" of a taxpayer is determined by rather specific and arbitrary statutory provisions. Section 21 defined "net income" as the gross income computed under Section 22 less the deductions allowed by Section 23. Both the normal tax on individuals imposed by Section 11 and the surtax imposed by Section 12 are imposed on "net income." However, Section 25 cuts across these provisions and requires a somewhat different result from that which would otherwise be required by a literal construction of Sections 11, 12, 21, 22, and 23. Section 25 allows as "credits against the net income" for normal tax purposes dividends received from domestic corporations, a personal credit of $3,500 for a married person, and a credit of $400 for each dependent. It is obvious from this review of the statutory provisions that two "net incomes" are provided for by the statute, viz., the net income which is defined in Section 21 and the "net income" to which the taxes under Sections 11 and 12 are applied. The earned income credit which is deducted from both normal and surtax, which would otherwise be payable, is provided for by Section 31 and is determined by reference to

the earned income of the taxpayer as distinguished from income from investments.

The above provisions are the only ones which affected the determination of the tax liability of the taxpayers Harwick and John V. Dobson for 1930 or 1931. However, numerous other provisions of the *Revenue Act of 1928* could affect the computation of net income and of tax. For example: Section 101 provides for the elimination of capital gains and losses from the "net income" subject to tax under Sections 11 and 12 in certain cases and the imposition of a separate tax. Section 116 provides that certain items normally within the concept of net income shall be excluded from gross income under Section 22. Section 115 excludes from gross income dividends paid by corporations out of pre-March 1, 1913, surplus. On the deduction side, after computation of "net income," Section 117 provides for the deduction under certain circumstances of losses sustained in previous years; Section 118 disallows so-called "wash-sale losses"; and Section 120 provides that the limitations on the deductions for contributions, which Section 23 sets at 15 per cent of net income before the deduction for contributions, shall not apply where the contributions are so substantial as to meet certain statutory requirements.

The above resumé of some of the provisions of the *Revenue Act of 1928* is intended to indicate the arbitrary nature of the term "net income" as used in that Act and the fact that a variety of definitions for that term can be evolved under different sections of the statute. Furthermore, the concept of "net income" has changed in the various Revenue Acts. For example: Certain corporate distributions which are not included in net income under the *Revenue Act of 1928* are included in net income under the *Revenue Act of 1936* (see Section 115, *Revenue Act of 1936*, 49 Stat. 1687) and interest on Federal bonds was not subject to tax under the Rev-

enue Act of 1928 but such interest on bonds issued since March 1, 1941, now is fully taxable. See Section 22, *Internal Revenue Code,* 53 Stat. 10, and Section 4, *Public Debt Act of 1941,* 55 Stat. 9.

IV.

The Portion of the Recovery From National City Company Which the Taxpayer Concedes in the Harwick Case or Which This Court (Contrary to Taxpayers' Contentions) May Hold in the Other Cases Is Taxable Income for 1939, Is Properly Taxable as "Long-Term Capital Gain" Under Section 117 of the Internal Revenue Code and Therefore Only Fifty Per Cent Thereof Is to Be Subjected to Tax.

Both the Board and the Circuit Court of Appeals concluded that, to the extent that the amounts received by the taxpayers from National City Company constituted taxable income, they were to be treated as ordinary income and not as long-term capital gains under Section 117 of the *Internal Revenue Code,* 53 Stat. 50.

Section 117 provides that when income is properly classified as long-term capital gain only fifty per cent thereof is to be taxed instead of taxing the entire gain as in the case of other income. Subdivision (a) (4) of Section 117 defines long-term capital gain as follows:

> "The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income."

It is not disputed that, to the extent the taxpayers realized taxable income, if any, from the recoveries here involved, such income was realized upon disposition of a capital asset and we believe that the Commissioner will concede that the capital asset was held more than 18 months. The sole ques-

tion to be decided, therefore, is whether the capital asset, upon which the gain was realized, was disposed of by the taxpayer in a "sale or exchange." It is the taxpayers' contention that whatever taxable income was realized as the result of a recovery from National City Company in 1939 was realized from a "sale or exchange" and therefore is taxable as capital gain. The determination of this issue requires an inquiry into the nature of the transaction which resulted in the recovery. As previously pointed out in this brief, the taxpayers' claims against National City Company were based on the right to rescind the purchases and secure a refund of the purchase price. It also is admitted by the Commissioner (R. 62) that where a taxpayer continued to hold his National City Bank of New York stock, the recovery in 1939 attributable to such stock was not taxable. It follows, therefore, that the receipt of income in 1939 (to whatever extent taxable) represented "gain from the sale" of the stock *in 1931* which was not taxable until 1939, at which time it was received by a cash basis taxpayer. The quoted phrase is from Section 117 of the Internal Revenue Code and it is submitted that it accurately describes the source of whatever gain may be deemed taxable in this case. It seems clear that even under the Commissioner's theory the taxable income was not "from" the recovery in 1939 because, unless there was a prior sale of the stock, there is no taxable income as the result of that recovery. The gain then must be "from" the sale of the stock in 1931. Although the Commissioner and the taxpayer may differ as to whether the 1931 sale caused part or all of such "gain" realized in 1939 to be taxable merely because the loss was claimed in 1931 or because the loss was of tax benefit in that year, we seem to be agreed that it was the 1931 sale which gives part or all of this 1939 recovery its character as taxable income, if it has that character at all. The mere fact that the gain was received and

taxed in a year long after 1931 should not prevent it from taking its character as capital gain from the events in 1931. A common example of a similar situation is found in the taxation of gain on installment sales under Section 44 of the *Internal Revenue Code,* 53 Stat. 24. Gains under this section are taxed in proportion to the amount received in years subsequent to the year of sale and such gains are classified as capital or ordinary gain pursuant to the law applicable to the year in which the gain is received. *Snell vs. Commissioner* (1938, C. C. A. 5), 97 Fed. (2d) 891.

The Circuit Court of Appeals rejected the above contentions of the taxpayers because (R. 135) "there was no causal relation between the sales in former years and the recoveries in the latter * * *. The sales of stock were completed transactions in 1930 and 1931 and they can neither in fact nor in law be coupled with a settlement in 1939 so as to transform the two transactions into a single sale or exchange of capital assets." Despite the above statement, the Commissioner and the Court found sufficient "causal relation" between the sales in 1930 and 1931 and the recoveries in 1939 to hold such recoveries constituted taxable income if, *and only if,* the recoveries were made with respect to stock which was *sold* in 1930 and 1931. Thereby the Commissioner and the Court "in fact and in law" coupled the sales in 1930 and 1931 with the recoveries in 1939. The meaning of words is often elusive but we submit that the quoted statement of the Court is clearly erroneous.

CONCLUSION

It is respectfully submitted, therefore, that this Court should hold James N. Collins, E. W. Dobson, John V. Dobson, and H. J. Harwick were taxable on no part of the recoveries realized in 1939 as a result of suits against National City Company which the Commissioner has added to their income. It is further submitted that this Court should hold that the portion of the recovery in 1939, which H. J. Harwick concedes to be taxable income, should be taxed as capital gain under Section 117 of the Internal Revenue Code rather than as ordinary income. For these reasons petitioners pray that the judgments of the United States Circuit Court of Appeals for the Eighth Circuit reversing the judgments of the United States Board of Tax Appeals be themselves reversed, and that the portions of the judgments of the United States Board of Tax Appeals questioned by the appeals therefrom taken by H. J. Harwick and John V. Dobson also be reversed.

Respectfully submitted,

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APPENDIX A

Facts involved in E. W. Dobson vs. Guy T. Helvering, Commissioner of Internal Revenue, No. 45, R. 80-83.

At various times in 1928, 1929, and 1931 E. W. Dobson purchased a total of 600 shares of the capital stock of the National City Bank of New York. The purchases were made in the State of Minnesota from the National City Company.

In 1929 E. W. Dobson sold 200 shares of the stock which had cost him $76,350 for $74,000, thereby sustaining a loss of $2,350. This loss was not claimed as a deduction in his 1929 income tax return because of the wash-sales provisions of the Revenue Act of 1928, and it would not have been allowed if it had been claimed.

In 1930 he sold 200 shares of the stock which had cost him $70,000 for $20,697.44, thereby sustaining a loss in the amount of $49,302.56, which loss was claimed as a deduction in his return for 1930. Although the deductible loss actually sustained on this sale was $2,350 greater than that claimed by the petitioner in his return, because of the increased basis resulting from the 1929 wash-sale, the deduction actually claimed by petitioner in his return of 1930 was not disturbed by the respondent because the return showed a net loss.

In 1931 he sold the remaining 200 shares of the stock which had cost him $17,700 for $16,000, thereby sustaining a deductible loss for income tax purposes in the amount of $1,700. This loss was claimed by him as a deduction from gross income in his return for 1931 and was allowed as a deduction by the Commissioner.

The suit by E. W. Dobson against National City for rescission of these purchases was settled in 1939 by a net payment of $32,384.80 by the company to E. W. Dobson, and upon receipt thereof the suit was dismissed with prejudice

pursuant to a stipulation between the parties. Of the total net recovery, $31,432.80 is allocable to the stock sold in 1930 and the balance of $952 is allocable to the stock sold in 1931. It is conceded that the last amount mentioned constituted taxable income for the year 1939 and was reported as income in his return for that year.

Of the deduction of $49,302.56, which was claimed and allowed on E. W. Dobson's 1930 income tax return, $5,983.51 thereof is attributable to 40 shares of stock which had been purchased in 1928 and none of the recovery in 1939 was attributable to such loss. If the balance of the deduction, $43,319.05, had been disallowed, no deficiency in income tax liability for 1930 would have resulted, as shown by the following computation:

Net loss per return		($30,197.56)
Add loss claimed on sale of National City Bank stock with respect to which E. W. Dobson made a recovery in 1939		43,319.05
Net income revised		13,121.49
Less:		
Dividends	$13,130.50	
Personal exemption	00.00	
Credit for dependents	00.00	
Total		13,130.60
Balance subject to normal tax		None
Normal tax: 1½% on first $4,000		None
Surtax on $13,121.49		31.21
Less earned income credit		39.25
Total tax assessable		None

If E. W. Dobson had received $31,432.80 on the sale of the stock in 1930, in addition to the amount actually received on such sale, the said $31,432.80 being the amount actually recovered in respect of such stock by reason of the settlement in 1939, his 1930 loss on the sale of the stock would

have been $20,219.76, and he would have had no income tax liability for that year, as shown by the following computation:

Net income as shown in original return		($30,197.56)
Add: Entire amount recovered in 1939 in reduction of loss on stock sold in 1930		31,432.80
Net income revised		1,235.24
Less:		
Dividends	$13,130.60	
Personal exemption	00.00	
Total		13,130.60
Balance subject to normal tax		None
Total tax assessable		None
Tax assessed		None
Deficiency		None

Throughout the year 1939 adjustment of E. W. Dobson's income tax liability for 1930 was barred by the Statute of Limitations.

In his income tax return for 1939, E. W. Dobson reported income of only $952 on account of the recovery of $32,384.80. In the deficiency notice the Commissioner adjusted the amount of gross income reported by adding thereto $31,432.80, thereby treating the entire amount of the net recovery of $32,384.80 as gross income.

The Board of Tax Appeals held that because the amount of the loss reported in the 1930 return of E. W. Dobson, viz., $30,197.56, increased by the loss not claimed, viz., $2,350, was in excess of the amount recovered in 1939 attributable to the stock sold in 1930, viz., $31,432.80, E. W. Dobson was not taxable on any portion of such recovery, but the entire amount constituted a recovery of the capital (R. 83).

Facts involved in John V. Dobson vs. Guy T. Helvering, Commissioner of Internal Revenue, No. 44, R. 105-109.

At various times in 1929 John V. Dobson purchased, in transactions entered into for profit, a total of 440 shares of the capital stock of the National City Bank of New York. The purchases were made in the State of Minnesota from the National City Company.

During the year 1929 John V. Dobson sold a total of 240 shares of the stock, 90 shares of which resulted in a taxable gain of $8,168.44 and was so treated in closing his income tax liability for 1929. The sale of the remaining 150 shares in 1929 resulted in a loss of $13,168.44, properly disallowed as a deduction in closing his 1929 income tax liability because of the wash sales provisions of the Revenue Act of 1928.

In 1930, John V. Dobson sold the remaining 200 shares of the stock for $20,897.44. These shares had actually cost $70,000, but, because of the wash sales in 1929 which resulted in nondeductible losses for that year, the basis for determining the amount of loss sustained in 1930 was $70,000, plus $13,168.44, or $83,168.44. The 1930 sale resulted in a deductible loss in the amount of $62,271, which was allowed by the Commissioner as a deduction in closing John V. Dobson's income tax liability for that year.

On July 3, 1931, John V. Dobson purchased 200 shares of the bank stock at a cost of $17,700, and on July 13, 1931, sold the said shares for $16,000, thereby sustaining a loss of $1,700, which was deductible for 1931, but was not claimed as a deduction. Upon audit of the return, no deduction was allowed by the Commissioner by reason of the loss realized on the sale, but had such loss been claimed as a deduction it would have been allowed and would have reduced the income tax liability of John V. Dobson for the year 1931, but

would not have eliminated entirely liability to tax. His 1931 return disclosed net income of $17,514.27, and a tax thereon of $125.43, which was paid to the Collector during the year 1932.

The suit of John V. Dobson against National City Company for rescission of these purchases was settled in 1939 by a net payment of $33,404 by the company, and upon receipt thereof the suit was dismissed, with prejudice, pursuant to a stipulation between the parties. Of the total net recovery, $157.04 related to 40 shares of stock which are not here involved and is conceded to be taxable income. Of the remainder, $32,294.95 is allocable to the stock sold in 1930 and the balance of $952 is allocable to the stock sold in 1931. The Commissioner concedes that this latter amount does not constitute income taxable to John V. Dobson in 1939.

If the entire deduction of $62,271, allowed as a deduction in connection with John V. Dobson's 1930 Federal income tax liability had been disallowed, there would have been net income in the amount of $32,227.53 and a deficiency in income tax for 1930 would have resulted in the amount of $1,232.75, computed as follows:

Net loss		($30,043.47)
Add: Loss on National City Bank stock, eliminated		62,271.00
Net income revised		32,227.53
Less:		
Dividends	$23,659.45	
Personal exemption	3,500.00	
Credits for dependents	1,200.00	28,359.45
		3,868.08
Normal tax: 1½% of $3,868.04		$ 57.02
Surtax on $32,227.53		1,240.48
Total		1,297.50

Total (Carried over)	$ 1,297.50
Less: Earned income credit	64.75
Total tax assessable	1,232.75
Assessed	0.00
Deficiency	1,232.75

If in addition to the $20,897.44 actually received on the sale of the stock in 1930 John V. Dobson had received $32,294.96, being the amount recovered in 1939 in respect of the stock sold in 1930, his deductible loss for 1930 from the sale of the said stock would have been $29,976.04 and he would have had net income in the amount of $2,251.49. Due to certain credits allowable, however, his income tax for 1930 would have been zero, shown as follows:

Net Loss		($30,043.47)
Add: Entire amount recovered in 1939 in reduction of loss on stock sold in 1930		32,294.96
Net income revised		2,251.49
Less:		
Personal exemption	$3,500.00	
Credit for dependents	1,200.00	
Total		4,700.00
Balance subject to tax		None
Total tax assessable		None
Tax assessed		None
Deficiency		None

Throughout the year 1939 adjustment of John V. Dobson's income tax liability for 1930 was barred by the Statute of Limitations.

In his income tax return for 1939 John V. Dobson reported income of only $157.04 on account of the recovery of $33,404. In the deficiency notice the Commissioner adjusted

the amount of gross income reported by adding $33,246.96 and thereby treating the entire amount of the net recovery of $33,404 as ordinary income.

The Board of Tax Appeals held that because the amount of loss reported in John V. Dobson's 1930 income tax return, viz., $30,043.47, was $2,251.49 less than the amount of the recovery attributable to the 1930 sales, viz., $32,294.96, he was taxable on $2,251.49 of such recovery, and that said amount was taxable as ordinary income rather than as capital gain under Section 117 of the Internal Revenue Code. The Board also held that John V. Dobson was not taxable on that portion of the recovery attributable to the sales in 1931, viz.: $952, inasmuch as this amount was less than the loss sustained on such sale, viz.: $1,700, and said loss had not been claimed or allowed as a deduction in John V. Dobson's 1931 income tax return.